



[4830-01-p]

## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9654]

RIN 1545-BL01

Guidance for Determining Stock Ownership

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that identify certain stock of a foreign corporation that is disregarded in calculating ownership of the foreign corporation for purposes of determining whether it is a surrogate foreign corporation.

These regulations also provide guidance with respect to the effect of transfers of stock of a foreign corporation after the foreign corporation has acquired substantially all of the properties of a domestic corporation or of a trade or business of a domestic partnership.

These regulations affect certain domestic corporations and partnerships (and certain parties related thereto), and foreign corporations that acquire substantially all of the properties of such domestic corporations or of the trades or businesses of such domestic partnerships. The text of the temporary regulations serves as the text of the proposed regulations set forth in the Proposed Rules section in this issue of the **Federal Register**. This document also contains a final regulation that provides a cross-reference to the temporary regulations.

DATES: Effective Date: These regulations are effective on **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.7874-4T(k) and 1.7874-5T(c).

FOR FURTHER INFORMATION CONTACT: David A. Levine, (202) 317-6937 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

## **Background**

### **A. Section 7874 -- In General**

A foreign corporation (foreign acquiring corporation) generally is treated as a surrogate foreign corporation under section 7874(a)(2)(B) of the Internal Revenue Code if pursuant to a plan (or a series of related transactions): (i) the foreign acquiring corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation; (ii) after the acquisition, at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation; and (iii) after the acquisition, the expanded affiliated group that includes the foreign acquiring corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized, when compared to the total business activities of the expanded affiliated group. Similar provisions apply if a foreign acquiring corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

Under section 7874(c)(2)(B) (statutory public offering rule), stock of the foreign acquiring corporation that is sold in a public offering related to the acquisition described in section 7874(a)(2)(B)(i) (acquisition) is not taken into account for purposes of calculating the ownership percentage described in section 7874(a)(2)(B)(ii) (ownership fraction). The statutory public offering rule furthers the policy that section 7874 is intended to curtail inversion transactions that “permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion.” S. Rep. No. 192, 108th Cong., 1st. Sess. 142 (2003); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05) (May 2005), at 343.

Under section 7874(c)(4), a transfer of properties or liabilities (including by contribution or distribution) is disregarded if such transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874. Section 7874(c)(6) grants the Secretary authority to prescribe regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat stock as not stock. In addition, section 7874(g) grants the Secretary authority to provide regulations necessary to carry out section 7874, including regulations adjusting the application of section 7874 as necessary to prevent the avoidance of the purposes of section 7874.

**B. Notice 2009-78**

On September 17, 2009, the IRS and the Department of the Treasury (Treasury Department) issued Notice 2009-78 (2009-40 IRB 452) (notice), which announced that regulations would be issued under section 7874 to identify certain stock of a foreign

acquiring corporation that is not taken into account in determining the ownership fraction. See §601.601(d)(2)(ii)(b) of this chapter.

The notice states that regulations will provide that stock of the foreign acquiring corporation issued in exchange for “nonqualified property” in a transaction related to the acquisition is not taken into account for purposes of the ownership fraction, without regard to whether such stock is publicly traded on the date of issuance or otherwise. The notice further provides that the term nonqualified property generally will mean: (i) cash or cash equivalents; (ii) marketable securities as defined in section 453(f)(2); and (iii) any other property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874.

The notice also states that regulations will clarify that certain stock of the foreign acquiring corporation, including certain stock otherwise described in the statutory public offering rule, nonetheless will be taken into account for purposes of the ownership fraction. Specifically, the notice states that marketable securities will not include stock of (or a partnership interest in) a member of the expanded affiliated group (as defined in section 7874(c)(1)) that, after the acquisition, includes the foreign acquiring corporation, unless a principal purpose of issuing the stock of the foreign acquiring corporation in exchange for such stock or partnership interest was the avoidance of the purposes of section 7874. Accordingly, even if issued in a public offering, stock of the foreign acquiring corporation issued in exchange for stock of (or a partnership interest in) a member of the expanded affiliated group that, after the acquisition, includes the foreign acquiring corporation, will be taken into account for purposes of the ownership fraction, unless a principal purpose of issuing the stock of the foreign acquiring corporation in

exchange for such stock or partnership interest was the avoidance of the purposes of section 7874.

The notice provides that the regulations will apply to acquisitions completed on or after September 17, 2009.

The temporary regulations set forth the rules described in the notice, subject to certain modifications, in part, to address comments received.

## **Explanation of Provisions**

### **A. New Exclusion Rule Modifies the Statutory Public Offering Rule**

Under the statutory public offering rule of section 7874(c)(2)(B), stock of the foreign acquiring corporation is not taken into account for purposes of the ownership fraction if the stock is sold in a public offering related to the acquisition. Absent the statutory public offering rule, the purposes of section 7874 could be avoided by having the foreign acquiring corporation issue stock to the public in exchange for cash in order to reduce the ownership fraction while not significantly altering the manner in which the domestic entity did business before the inversion transaction. Consistent with the notice, the IRS and the Treasury Department believe that stock of the foreign acquiring corporation transferred in exchange for certain property in a transaction related to the acquisition, but not through a public offering, presents the same opportunity to inappropriately reduce the ownership fraction. For example, a private placement of the stock of a foreign acquiring corporation in exchange for cash raises the same policy concern that the ownership fraction will be inappropriately reduced by increasing the net assets of the foreign acquiring corporation.

Consistent with the notice, the IRS and the Treasury Department also believe that the statutory public offering rule can result in an over-inclusive application of section 7874 to certain business combinations. That is, the statutory public offering rule can apply to certain business combinations in which the unrelated shareholders of a foreign target corporation receive publicly traded stock of the foreign acquiring corporation in transactions that, while they do increase the net assets of the foreign acquiring corporation, generally are expected to meaningfully alter the way the expanded affiliated group that includes the foreign acquiring corporation does business and therefore such publicly traded stock should be taken into account in calculating the ownership fraction.

To address these concerns, the temporary regulations modify the statutory public offering rule (as modified, the exclusion rule). Specifically, the exclusion rule provides that, subject to a de minimis exception, disqualified stock (described in section B of this preamble) is excluded from the denominator of the ownership fraction. Because the determination of whether stock of the foreign acquiring corporation is disqualified stock is made without regard to whether it is publicly traded at the time of the transfer or at any other time, the exclusion rule under the temporary regulations addresses the potentially under-inclusive application of section 7874 under the statutory public offering rule. Moreover, although the notice excluded stock of the foreign acquiring corporation from the denominator of the ownership fraction only when there was an issuance of such stock, the IRS and the Treasury Department do not believe the exclusion rule should be limited to stock of the foreign acquiring corporation that is issued in the transaction. Accordingly, under the temporary regulations, disqualified stock is stock of the foreign acquiring corporation that is transferred in a manner described in the

temporary regulations, regardless of whether the transfer occurs by reason of an issuance, sale, distribution, exchange, or any other type of disposition and regardless of whether the stock is transferred by the foreign acquiring corporation or another person.

The temporary regulations describe all situations in which stock will be excluded from the denominator of the ownership fraction under section 7874(c)(2)(B). Thus, even when a foreign acquiring corporation issues stock in a public offering, the statutory public offering rule will not exclude such stock from the denominator unless the stock is disqualified stock. Accordingly, the exclusion rule also addresses the potentially over-inclusive application of the statutory public offering rule.

Because stock of the foreign acquiring corporation held by former shareholders or former partners by reason of holding stock or a partnership interest in the domestic entity will never be subject to the nonqualified property rule or the associated liability rule, the exclusion rule will never apply to such stock.

**B. Identifying Stock of the Foreign Acquiring Corporation that is Disqualified Stock**

**1. Stock transferred in a transaction that does not increase the net assets of the foreign acquiring corporation is not disqualified stock**

Comments questioned whether the rules described in the notice would exclude from the denominator of the ownership fraction stock of the foreign acquiring corporation that is transferred by persons that are not members of the expanded affiliated group that includes the foreign acquiring corporation in exchange for nonqualified property. Such a transfer may occur, for example, if an individual holds stock of the foreign acquiring corporation at the time of the acquisition and sells such stock to another individual for cash (which is nonqualified property) in a transaction related to the acquisition.

The purpose of the exclusion rule is to prevent certain stock of the foreign acquiring corporation that is transferred in a transaction that increases the net assets of the foreign acquiring corporation from inappropriately increasing the denominator of the ownership fraction and thereby reducing the ownership fraction. Thus, provided that the stock of the foreign acquiring corporation that is transferred is not hook stock (that is, where the foreign acquiring corporation holds a direct or indirect interest in the selling shareholder), the IRS and the Treasury Department do not believe that the exclusion rule should apply to transfers of stock by a shareholder of the foreign acquiring corporation to another person because such transfers do not increase the net assets of the foreign acquiring corporation. Accordingly, the temporary regulations provide that stock of the foreign acquiring corporation is disqualified stock if the stock is transferred in exchange for certain property but only to the extent the exchange increases the net assets of the foreign acquiring corporation (that is, the exchange increases the fair market value of the assets of the foreign acquiring corporation or decreases the amount of its liabilities). The extent to which such an exchange increases the net assets of the foreign acquiring corporation is determined on a transfer-by-transfer basis. Therefore, a related transaction that might decrease the net assets of the foreign acquiring corporation, such as a related distribution by the foreign acquiring corporation with respect to its stock, is not taken into account for purposes of determining whether a specific transfer of stock in exchange for property increases the net assets of the foreign acquiring corporation.

2. Stock of the foreign acquiring corporation that generally is disqualified stock

Under the temporary regulations, stock of the foreign acquiring corporation that is transferred in any transaction described in section B.2.a. or B.2.b. of the preamble is treated as disqualified stock if the transaction is related to the acquisition, unless the exception described in section B.1. of the preamble applies.

(a) Transfers of stock in exchange for nonqualified property

Disqualified stock includes stock of the foreign acquiring corporation that is transferred to a person other than the domestic entity in exchange for nonqualified property (nonqualified property rule). Transfers of stock of the foreign acquiring corporation to the domestic entity in exchange for nonqualified property are not subject to the nonqualified property rule because such transferred stock generally is treated as either: (i) stock that is received by reason of holding stock or a partnership interest in the domestic entity (for example, if the domestic entity is a corporation that distributes the transferred stock to its shareholders in cancellation of their stock in the domestic entity), and, therefore, generally is included in the numerator and the denominator of the ownership fraction; or (ii) disqualified stock under the associated obligation rule described in paragraph (b) of this section B.2. of the preamble.

The term nonqualified property means: (i) cash or cash equivalents; (ii) marketable securities within the meaning of section 453(f)(2), as modified by the temporary regulations; (iii) a disqualified obligation; or (iv) any other property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874. A disqualified obligation is an obligation (as defined in §1.752-1(a)(4)(ii)) of any of the following persons: (i) a member of the expanded affiliated group that includes the foreign acquiring corporation; (ii) a

former shareholder (within the meaning of §1.7874-2(b)(2)) or former partner (within the meaning of §1.7874-2(b)(3)) of the domestic entity; or (iii) a person that, before or after the acquisition, either owns stock of, or a partnership interest in, any person described in (i) or (ii) or is related (within the meaning of section 267 or 707(b)) to any such persons.

In the notice, the definition of nonqualified property includes cash, cash equivalents, and marketable securities, but not a disqualified obligation. Nevertheless, based on further consideration, the IRS and the Treasury Department believe that, for purposes of the temporary regulations, a transfer of stock of the foreign acquiring corporation in exchange for a disqualified obligation should be treated similarly to transfers of stock of the foreign acquiring corporation in exchange for cash, cash equivalents, and marketable securities because such transfers present similar opportunities to inappropriately reduce the ownership fraction by increasing the net assets of the foreign acquiring corporation.

Consistent with the notice, the temporary regulations exclude from the definition of marketable securities (which constitute nonqualified property) stock of a corporation (or an interest in a partnership) that becomes a member of the expanded affiliated group that includes the foreign acquiring corporation in a transaction related to the acquisition, unless a principal purpose of the acquisition of such stock (or partnership interest) was the avoidance of the purposes of section 7874. Thus, for example, subject to an anti-abuse rule, publicly traded stock of a foreign target corporation does not constitute marketable securities for purposes of the temporary regulations and therefore is not nonqualified property.

In addition, the IRS and the Treasury Department believe that a transfer of stock of the foreign acquiring corporation in exchange for the satisfaction or the assumption of an obligation of the transferor should be treated similarly to a transfer of stock of the foreign acquiring corporation in exchange for nonqualified property because such a transfer also presents opportunities to inappropriately reduce the ownership fraction by increasing the net assets of the foreign acquiring corporation. For example, if the foreign acquiring corporation is a debtor with respect to an obligation and satisfies the obligation with its stock, the transfer of the stock to the creditor in satisfaction of the obligation increases the net assets of the foreign acquiring corporation, and, absent a special rule, would increase the denominator of the ownership fraction. Accordingly, under the temporary regulations, disqualified stock includes stock of the foreign acquiring corporation that is transferred to a person other than the domestic entity in exchange for the satisfaction or the assumption of an obligation of the transferor. Solely for purposes of applying the temporary regulations, stock of the foreign acquiring corporation described in the preceding sentence is treated as if it were transferred to the transferee in exchange for an amount of cash (which is nonqualified property) equal to the fair market value of the stock of the foreign acquiring corporation that is transferred in exchange for the satisfaction or the assumption of the obligation.

One comment suggested that the phrase “related to the acquisition” in section 7874(c)(2)(B) can be read to suggest that the statutory public offering rule should apply only if the proceeds of a public offering are used to acquire, or fund the business of, the domestic entity. Accordingly, the comment suggested that the statutory public offering rule should not apply if, for example, the proceeds are used to acquire business assets

unrelated to those of the domestic entity. Another comment recommended an exception to the statutory public offering rule for offerings that further a significant business purpose, such as allowing an insolvent domestic entity to continue its operations. The IRS and the Treasury Department believe that the use of the offering proceeds is irrelevant to the application of the statutory public offering rule. Neither the statute nor the legislative history indicates that Congress intended for the statutory public offering rule to apply based on the use of the proceeds. Accordingly, the temporary regulations do not adopt these recommendations. Therefore, the determination of whether stock of the foreign acquiring corporation transferred in exchange for nonqualified property is disqualified stock is made without regard to the use of the nonqualified property.

- (b) Subsequent transfers of stock in exchange for the satisfaction or the assumption of an obligation associated with property exchanged

The IRS and the Treasury Department believe that a transfer of stock of the foreign acquiring corporation in exchange for property when the transferee subsequently transfers the stock in exchange for the satisfaction or the assumption of the transferee's obligations associated with the property exchanged also presents opportunities to inappropriately decrease the ownership fraction. For example, assume that a domestic entity (DE) has \$100x of assets employed in a trade or business and \$25x of obligations that arose from conducting that trade or business. A foreign acquiring corporation (FA) wants to acquire all the assets of DE in a transaction in which DE will liquidate. FA could acquire the \$100x of assets of DE by issuing \$75x of stock and assuming the \$25x of obligations, in which case DE would distribute the \$75x of FA stock to its shareholders in liquidation. Alternatively, FA could acquire the \$100x of

assets of DE by issuing \$100x of stock and not assuming the \$25x of obligations, in which case DE would transfer \$25x of FA stock to satisfy the \$25x of obligations and distribute the remaining \$75x of FA stock to its shareholders in liquidation. In either case, the shareholders of DE will receive \$75x of FA stock by reason of holding stock in DE and FA will own the \$100x of assets formerly owned by DE; however, absent a special rule, the denominator of the ownership fraction would not be the same in both cases. In the first case, the denominator would include only \$75x of FA stock and FA would owe the \$25x of obligations. In the second case, the denominator would include \$100x of FA stock and FA would not owe the \$25x of obligations. In the latter case, the ownership fraction would be inappropriately reduced.

Accordingly, to address such transfers, the temporary regulations provide that disqualified stock includes stock of the foreign acquiring corporation transferred to a person (including the domestic entity) in exchange for property to the extent, pursuant to the same plan (or series of related transactions), the transferee subsequently transfers the stock in exchange for the satisfaction or the assumption of an obligation associated with the property exchanged (associated obligation rule). An obligation is associated with property exchanged if, for example, the obligation arose from the conduct of a trade or business in which the property exchanged has been used, regardless of whether the obligation is a non-recourse obligation. For an example of a rule that applies when liabilities associated with a trade or business are assumed by a corporate transferee of the trade or business in certain nonrecognition exchanges, see section 358(h)(2).

In this case, the requirement that the transfer of stock of the foreign acquiring corporation increase the net assets of the foreign acquiring corporation applies only with

respect to the transfer of the stock in exchange for property of the transferee, and not with respect to the subsequent transfer of the stock of the foreign acquiring corporation by the transferee in exchange for the satisfaction or the assumption of an obligation of the transferee.

Unlike the nonqualified property rule, which does not apply to a transfer of stock of the foreign acquiring corporation to the domestic entity, the associated obligation rule may apply to a transfer of stock of the foreign acquiring corporation to the domestic entity to the extent the stock is subsequently transferred by the domestic entity in exchange for the satisfaction or the assumption of one or more of the domestic entity's obligations associated with the property exchanged. This treatment is appropriate because, in such a case, the stock of the foreign acquiring corporation transferred will not be included in the numerator of the ownership fraction (because the creditor with respect to the obligation or the person that assumes the obligation, as the case may be, does not receive the stock of the foreign acquiring corporation by reason of holding stock or a partnership interest in the domestic entity).

The temporary regulations limit the application of the associated obligation rule when the property exchanged (including cash deemed to be exchanged when stock of the foreign acquiring corporation is transferred in exchange for the satisfaction or the assumption of an obligation of the transferor) includes nonqualified property and the person exchanging the property is not the domestic entity. The limitation has the effect of treating a portion of the obligation as being satisfied with stock of the foreign acquiring corporation that is disqualified stock under the nonqualified property rule (with the result that such portion does not give rise to additional disqualified stock under the

associated obligation rule) and the remaining portion of the obligation as being satisfied with stock of the foreign acquiring corporation that is not disqualified stock under the nonqualified property rule (with the result that satisfaction of this portion of the obligation with stock of the foreign acquiring corporation gives rise to additional disqualified stock under the associated obligation rule). The portions of an obligation described in the preceding sentence are determined based on the relative amount of nonqualified property and qualified property exchanged, respectively. This limitation does not apply when stock of the foreign acquiring corporation is transferred to the domestic entity because the nonqualified property rule does not apply to such transfers of stock.

#### C. Different Treatment for Stock and Asset Acquisitions

One comment noted that under the notice the amount of nonqualified property exchanged for stock of the foreign acquiring corporation can differ depending on whether the stock or assets of a corporation are acquired. For example, if a foreign acquiring corporation issues stock in exchange for all of the stock of another foreign corporation in a transaction related to the acquisition, none of the stock of the foreign acquiring corporation is considered to be issued in exchange for nonqualified property, without regard to whether the acquired foreign corporation held nonqualified property, unless a principal purpose of the acquisition of the stock of such acquired foreign corporation is the avoidance of the purposes of section 7874. The comment further noted that, if the transaction instead is structured as the acquisition of all the assets of the acquired foreign corporation, the stock of the foreign acquiring corporation would not be taken into account to the extent it is treated as issued in exchange for nonqualified property held by the acquired foreign corporation. The comment suggested that the

dissimilar treatment is not supported by policy and raises form-over-substance concerns.

The structure of a transaction as an acquisition of stock or assets can often result in different U.S. tax consequences. In addition, the IRS and the Treasury Department believe that the complexity of adopting rules to harmonize the treatment of stock and asset acquisitions, such as by applying a look-through approach to stock acquisitions, would outweigh the benefits of consistent treatment. Moreover, the IRS and the Treasury Department believe that the treatment of property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874 as nonqualified property addresses the concern that taxpayers may exploit this dissimilar treatment by engaging in transactions intended to convert nonqualified property into stock that is not nonqualified property. See Example 2 of §1.7874-4T(j) of the temporary regulations. Accordingly, the temporary regulations do not adopt this recommendation.

#### D. De Minimis Exception

Comments asserted that both the statutory public offering rule and the rule set forth in the notice that disregards stock issued in exchange for nonqualified property can lead to inappropriate results when the former owners of the domestic entity own only a minimal equity interest in the foreign acquiring corporation after the acquisition. These comments recommended that, in such a case, the regulations provide exceptions from the application of those rules.

First, comments recommended an exception for large cash public or private offerings where the cash remains in the foreign acquiring corporation and results in a change of ownership in the domestic entity of such a magnitude that the predominant

effect of the transaction is that of a sale or joint venture. Because such offerings have independent economic significance, comments suggested that they should not be treated as “related to” the acquisition, so that they would be taken into account for purposes of the ownership fraction.

Second, comments recommended an exception for transactions that in substance resemble a purchase by the foreign acquiring corporation of a substantial portion of the stock of the domestic entity from the former owners of the domestic entity. The comments asserted that this may occur, for example, when a significant amount of the consideration received by the former owners of the domestic entity is cash (or other nonqualified property) that, related to the acquisition, was received by the foreign acquiring corporation in exchange for its stock (which stock would not be taken into account in determining the ownership fraction under the notice). The comments stated that section 7874 should not apply to such transactions because the former owners of the domestic entity sold the majority of their interests in the domestic entity. These comments recommended that the exclusion rule be limited to transactions in which the former owners of the domestic entity own at least a threshold percentage of the equity of the foreign acquiring corporation.

The IRS and the Treasury Department agree that an exception from the exclusion rule is appropriate for certain transactions, but believe that any such exception should apply only when the former owners of the domestic entity own a de minimis equity interest in the foreign acquiring corporation after the acquisition. Accordingly, the temporary regulations provide that the exclusion rule will not apply to

certain transactions involving unrelated parties if the ownership fraction, determined without regard to the exclusion rule, is less than five percent (by vote and value).

E. Effect of Subsequent Transfers of Stock of the Foreign Acquiring Corporation Related to the Acquisition

Comments questioned the effect on the ownership fraction of certain subsequent transfers of stock of the foreign acquiring corporation in transactions related to the acquisition. This may occur, for example, when former shareholders of the domestic corporation receive stock of the foreign acquiring corporation by reason of holding stock in the domestic corporation and then transfer that stock to another person pursuant to the terms of a binding commitment that was in effect at the time of the acquisition.

The IRS and the Treasury Department believe that determining the ownership fraction by taking into account such subsequent transfers of stock of the foreign acquiring corporation could inappropriately reduce the numerator of the ownership fraction and thereby reduce the ownership fraction. For example, if such a subsequent transfer of stock of the foreign acquiring corporation were taken into account in determining the ownership fraction, the exclusion rule could be avoided by restructuring an inversion transaction so that an investor participates by purchasing stock of the foreign acquiring corporation received by a former owner of the domestic entity instead of purchasing newly issued stock of the foreign acquiring corporation. Accordingly, the temporary regulations clarify that stock of the foreign acquiring corporation that is described in section 7874(a)(2)(B)(ii) will not cease to be so described as a result of any subsequent transfer of the stock by the former shareholder or former partner of the domestic entity that received such stock, even if the subsequent transfer is related to the acquisition.

In addition, the IRS and the Treasury Department continue to study the extent to which such subsequent transfers of stock of the foreign acquiring corporation should be taken into account in applying section 7874(c)(2)(A) (which disregards stock held by members of the expanded affiliated group that includes the foreign acquiring corporation) and §1.7874-1 (which provides exceptions to the application of section 7874(c)(2)(A)) (collectively, with the rule of section 7874(c)(2)(A), the expanded affiliated group rules). Section K of the preamble to temporary and final regulations published on June 12, 2009 (TD 9453, 2009-28 IRB 114), describes certain divisive transactions described in section 355 that involve subsequent distributions by a corporation of the stock of the foreign acquiring corporation that is described in section 7874(a)(2)(B)(ii). These issues can also arise when there is a subsequent sale by a corporation of the stock of the foreign acquiring corporation, or in connection with an acquisitive asset reorganization described in section 368 in which the target corporation distributes such stock. In each of these cases, a corporation receives and only temporarily holds the stock of the foreign acquiring corporation, and, after the transfer of such stock, the corporation no longer is a member of the expanded affiliated group that includes the foreign acquiring corporation. The IRS and the Treasury Department request comments on whether different results may be appropriate depending on whether the corporation that receives the stock of the foreign acquiring corporation and only temporarily holds that stock is a foreign or domestic corporation.

F. Interaction of Exclusion Rule with Expanded Affiliated Group Rules

One comment questioned the interaction of the rules set forth in the notice with the expanded affiliated group rules in cases other than those involving subsequent

transfers of the stock of the foreign acquiring corporation (which are discussed in section E of this preamble). The comment suggested that stock of the foreign acquiring corporation that is disregarded under the rules set forth in the notice nonetheless should be taken into account for purposes of determining whether an entity is a member of an expanded affiliated group that includes the foreign acquiring corporation under section 7874(c)(2)(A), as well as for purposes of the “internal group restructuring” and “loss of control” exceptions to section 7874(c)(2)(A) provided in §1.7874-1(c). The comment further suggested that the policy underlying the internal group restructuring and loss of control exceptions requires that stock that would be included in the denominator of the ownership fraction under those exceptions should continue to be so included even if such stock would otherwise be excluded under the exclusion rule.

The IRS and the Treasury Department believe that the policies underlying the exclusion rule differ from those underlying the expanded affiliated group rules such that they should operate independently. Because the exclusion rule and the expanded affiliated group rules operate independently, the IRS and the Treasury Department do not believe that qualification for the internal group restructuring or loss of control exceptions should cause stock of the foreign acquiring corporation that would otherwise be excluded from the denominator of the ownership fraction under the exclusion rule to be included in the denominator of the ownership fraction. Instead, the IRS and the Treasury Department believe that the de minimis exception is the appropriate exception to the exclusion rule when the former owners own only a small equity interest in the foreign acquiring corporation after the acquisition. Accordingly, the temporary regulations provide that stock of the foreign acquiring corporation to which the exclusion

rule applies is not included in the denominator of the ownership fraction regardless of whether it would otherwise be included in the denominator as a result of the acquisition being described in the internal group restructuring exception or loss of control exception. That is, stock of the foreign acquiring corporation will not be taken into account in the denominator of the ownership fraction if either the exclusion rule or the expanded affiliated group rule set forth in section 7874(c)(2)(A) and §1.7874-1(b) applies to such stock. However, consistent with the comment, the temporary regulations provide that the exclusion rule does not apply for purposes of applying the expanded affiliated group rules.

#### G. Certain Public Offerings

The IRS and the Treasury Department are aware that the de minimis exception (described in section D of this preamble) may facilitate the acquisition of a domestic corporation by a foreign corporation in circumstances that implicate the policies underlying section 7874. This may occur, for example, in connection with the buyout of a publicly traded domestic corporation. In such a transaction, the buyer may contribute cash to a newly formed foreign acquiring corporation that uses such cash, along with the proceeds from borrowings and a small amount of its stock, to acquire all of the stock of a publicly traded domestic corporation. The small amount of stock of the foreign acquiring corporation often is issued to the management of the domestic corporation. After a period of time, the buyer may sell its stock of the foreign acquiring corporation pursuant to a public offering. The public offering of the stock of the foreign acquiring corporation may have been one of the intended exit strategies of the buyer when it

organized the foreign acquiring corporation to acquire the stock of the domestic corporation.

The IRS and the Treasury Department believe that these transactions, which have the effect of converting a publicly traded domestic corporation into a publicly traded foreign corporation over time, can be viewed as inconsistent with the policies underlying section 7874. The IRS and the Treasury Department are studying these transactions and request comments on the application of section 7874 to such transactions.

H. Effective/Applicability Date

The rules described in the notice and set forth in the temporary regulations apply to acquisitions completed on or after September 17, 2009. All other rules set forth in the temporary regulations apply to acquisitions completed on or after **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER]**.

However, a taxpayer may elect to apply all the rules of the temporary regulations to acquisitions completed before **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER]** if the taxpayer applies all of the rules consistently to all acquisitions completed before such date.

Comments recommended an exception to the rules described in the notice for transactions that were subject to a binding commitment but not completed before September 17, 2009. Because the rules described in the notice address transactions that are intended to avoid the purposes of section 7874, the IRS and the Treasury Department do not believe that providing a binding commitment exception is

appropriate. Therefore, the applicability date in the temporary regulations does not include a binding commitment exception.

No inference is intended as to the treatment of transactions described in the temporary regulations under the law before the applicability date of these regulations. The IRS may, where appropriate, challenge such transactions under applicable provisions, including under section 7874(c)(4) or judicial doctrines such as the substance-over-form doctrine.

### **Effect on Other Documents**

Notice 2009-78 (2009-40 IRB 452) is obsolete as of [INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER].

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble of the cross-referenced notice of proposed rulemaking published in this issue of the **Federal Register**. Pursuant to section 7805(f), these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

### **Drafting Information**

The principal authors of the temporary regulations are David A. Levine of the Office of Associate Chief Counsel (International) and Mary W. Lyons, formerly of the

Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.7874-4T also issued under 26 U.S.C. 7874(c)(6) and (g).

Section 1.7874-5T also issued under 26 U.S.C. 7874(c)(6) and (g).

Par. 2. Section 1.7874-1 is amended by adding a sentence at the end of paragraph (c)(1) to read as follows:

§1.7874-1 Disregard of affiliate-owned stock.

\* \* \* \* \*

(c) \* \* \* (1) \* \* \* For rules addressing the interaction of this section and §1.7874-4T, see §1.7874-4T(h).

\* \* \* \* \*

Par. 3. Section 1.7874-4T is added to read as follows:

§1.7874-4T Disregard of certain stock related to the acquisition (temporary).

(a) Scope. This section identifies certain stock of the foreign acquiring corporation that is disregarded in determining the ownership fraction (as defined in

paragraph (i)(9) of this section) and modifies the scope of section 7874(c)(2)(B).

Paragraph (b) of this section sets forth the general rule that certain stock of the foreign acquiring corporation, and only such stock, is treated as stock described in section 7874(c)(2)(B) and therefore is excluded from the denominator of the ownership fraction.

Paragraph (c) of this section identifies the stock of the foreign acquiring corporation that is subject to paragraph (b) of this section. Paragraph (d) of this section provides a de minimis exception to the application of the general exclusion rule of paragraph (b) of this section. Paragraph (e) of this section addresses transfers of stock of the foreign acquiring corporation involving certain obligations. Paragraph (f) of this section provides rules for certain transfers of stock of the foreign acquiring corporation involving multiple properties or obligations. Paragraph (g) of this section provides rules for the treatment of partnerships, and paragraph (h) of this section provides rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and §1.7874-1. Paragraph (i) of this section provides definitions.

Paragraph (j) of this section provides examples illustrating the application of the rules of this section. Paragraph (k) of this section provides dates of applicability, and paragraph (l) of this section provides the date of expiration.

(b) Exclusion of disqualified stock under section 7874(c)(2)(B). Except as provided in paragraph (d) of this section, disqualified stock (as determined under paragraph (c) of this section) is treated as stock described in section 7874(c)(2)(B) and therefore is not included in the denominator of the ownership fraction. Section 7874(c)(2)(B) shall not apply to exclude stock from the denominator of the ownership fraction that is not disqualified stock.

(c) Disqualified stock--(1) General rule. Except as provided in paragraph (c)(2) of this section, disqualified stock is stock of the foreign acquiring corporation that is transferred in an exchange described in paragraph (c)(1)(i) or (c)(1)(ii) of this section that is related to the acquisition. This paragraph (c) applies without regard to whether the stock of the foreign acquiring corporation is publicly traded at the time of the transfer or at any other time.

(i) Exchange for nonqualified property. The stock is transferred to a person other than the domestic entity in exchange for nonqualified property. See Example 1, Example 2, Example 5, Example 7, and Example 8 of paragraph (j) of this section for illustrations of this paragraph (c)(1)(i).

(ii) Certain obligations associated with property exchanged for stock. Except as otherwise provided in this paragraph (c)(1)(ii), the stock is transferred to a person in exchange for property and, pursuant to the same plan (or series of related transactions), the transferee subsequently transfers such stock in exchange for the satisfaction or the assumption of one or more obligations associated with the property exchanged. An obligation is associated with property exchanged if, for example, the obligation arose from the conduct of a trade or business in which the property exchanged has been used, regardless of whether the obligation is a non-recourse obligation. If any of the property exchanged constitutes nonqualified property and the transferee is not the domestic entity, the amount of stock described in this paragraph (c)(1)(ii) is limited to the product of:

(A) The fair market value of the stock subsequently transferred by the transferee in exchange for the satisfaction or the assumption of such obligations; and

(B) A fraction, the numerator of which is the amount of qualified property exchanged by the transferee, and the denominator of which is the total amount of property exchanged by the transferee. See Example 5 of paragraph (j) of this section for an illustration of this paragraph (c)(1)(ii).

(2) Stock transferred in an exchange that does not increase the fair market value of the assets or decrease the amount of liabilities of the foreign acquiring corporation.

Stock is disqualified stock only to the extent that the transfer of the stock in the exchange increases the fair market value of the assets of the foreign acquiring corporation or decreases the amount of its liabilities. This paragraph (c)(2) is applied to an exchange without regard to any other exchange described in paragraph (c)(1)(i) or (c)(1)(ii) of this section or any other transaction related to the acquisition. See Example 3 and Example 6 of paragraph (j) of this section for illustrations of this paragraph (c)(2).

(d) Exception to exclusion of disqualified stock--(1) De minimis ownership.

Except as provided in paragraph (d)(2) of this section, paragraph (b) of this section does not apply if both:

(i) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section, is less than five percent (by vote and value); and

(ii) After the acquisition and all transactions related to the acquisition, if any, are completed, former shareholders (within the meaning of §1.7874-2(b)(2)) or former partners (within the meaning of §1.7874-2(b)(3)), as applicable, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a

partnership interest in) any member of the expanded affiliated group that includes the foreign acquiring corporation. See Example 4 of paragraph (j) of this section for an illustration of this paragraph (d).

(2) Stock issued to avoid the purposes of section 7874. The exception in paragraph (d)(1) of this section does not apply to disqualified stock that is transferred in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874.

(e) Satisfaction or assumption of obligations. Except to the extent paragraph (c)(1)(ii) of this section applies, this paragraph (e) applies if, in a transaction related to the acquisition, stock of the foreign acquiring corporation is transferred to a person other than the domestic entity in exchange for the satisfaction or the assumption of one or more obligations of the transferor. In such a case, solely for purposes of this section, the stock of the foreign acquiring corporation is treated as if it is transferred in exchange for an amount of cash equal to the fair market value of such stock.

(f) Transactions involving multiple properties. For purposes of this section, if stock and other property are exchanged for qualified property and nonqualified property, the stock is treated as transferred in exchange for the qualified property or nonqualified property, respectively, based on the relative value of the property. See also §1.7874-2(f)(2) (allocating stock of the foreign acquiring corporation between an interest in the domestic entity and other property).

(g) Treatment of partnerships. For purposes of this section, if one or more members of the expanded affiliated group own, in the aggregate, more than 50 percent

(by value) of the interests in a partnership, such partnership is treated as a corporation that is a member of the expanded affiliated group.

(h) Interaction with expanded affiliated group rules. Disqualified stock that is excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section is taken into account for purposes of determining whether an entity is a member of the expanded affiliated group for purposes of applying section 7874(c)(2)(A) and determining whether an acquisition qualifies as an internal group restructuring or results in a loss of control, as described in §1.7874-1(c)(2) and (c)(3), respectively. However, such disqualified stock is excluded from the denominator of the ownership fraction for purposes of section 7874(a)(2)(B)(ii) regardless of whether it would otherwise be included in the denominator of the ownership fraction as a result of the application of §1.7874-1(c). See Example 7 and Example 8 of paragraph (j) of this section for illustrations of this paragraph (h).

(i) Definitions. The following definitions apply for purposes of this section:

(1) An acquisition is an acquisition described in section 7874(a)(2)(B)(i).

(2) A domestic entity is a domestic corporation or domestic partnership described in section 7874(a)(2)(B)(i).

(3) An expanded affiliated group is an affiliated group defined in section 7874(c)(1) determined as of the end of the day on which the acquisition is completed. A member of the expanded affiliated group is an entity included in the expanded affiliated group.

(4) A foreign acquiring corporation is a foreign corporation described in section 7874(a)(2)(B).

(5) An interest in a partnership has the meaning provided under §1.7874-2(b)(4), and therefore includes a capital or profits interest.

(6) Marketable securities has the meaning set forth in section 453(f)(2), except that the term marketable securities does not include stock of a corporation or an interest in a partnership that becomes a member of the expanded affiliated group that includes the foreign acquiring corporation in a transaction (or series of transactions) related to the acquisition, unless a principal purpose for acquiring such stock or partnership interest is to avoid the purposes of section 7874. See Example 3 of paragraph (j) of this section for an illustration of this paragraph (i)(6).

(7) Nonqualified property is property described in paragraphs (i)(7)(i) through (i)(7)(iv) of this section. Qualified property is property other than nonqualified property.

(i) Cash or cash equivalents.

(ii) Marketable securities, within the meaning of paragraph (i)(6) of this section.

(iii) An obligation owed by any of the following:

(A) A member of the expanded affiliated group that includes the foreign acquiring corporation;

(B) A former shareholder (within the meaning of §1.7874-2(b)(2)) or former partner (within the meaning of §1.7874-2(b)(3)) of the domestic entity; or

(C) A person that, before or after the acquisition, either owns stock of, or a partnership interest in, a person described in paragraph (i)(7)(iii)(A) or (i)(7)(iii)(B) of this section or is related (within the meaning of section 267 or 707(b)) to such a person. See Example 5 of paragraph (j) of this section for an illustration of this paragraph (i)(7)(iii).

(iv) Any other property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874.

See Example 2 of paragraph (j) of this section for an illustration of this paragraph (i)(7)(iv).

(8) An obligation has the meaning set forth in §1.752-1(a)(4)(ii), provided that the obligation is not otherwise treated as stock for purposes of section 7874 (see, for example, §1.7874-2(i), which treats certain interests, including certain creditor claims, as stock).

(9) The ownership fraction is the ownership percentage described in section 7874(a)(2)(B)(ii), expressed as a fraction.

(10) A transfer is, with respect to stock of the foreign acquiring corporation, an issuance, sale, distribution, exchange, or any other disposition of such stock.

(j) Examples. The following examples illustrate the rules of this section. For purposes of the examples, unless otherwise indicated, assume the following facts in addition to the facts stated in the examples:

(1) FA, FMS, FS, and FT are foreign corporations, all of which have only one class of stock issued and outstanding;

(2) DMS and DT are domestic corporations;

(3) P and R are corporations that may be either domestic or foreign;

(4) PRS is a partnership with individual partners;

(5) The de minimis ownership exception in paragraph (d)(1) of this section does not apply;

(6) None of the shareholders or partners in the entities described in the examples are related persons;

(7) All transactions described in each example occur pursuant to the same plan; and

(8) No property is acquired with a principal purpose of avoiding the purposes of section 7874.

Example 1. Stock transferred in exchange for marketable securities. (i) Facts. Individual A wholly owns DT. PRS transfers marketable securities (within the meaning of paragraph (i)(6) of this section) to FA, a newly formed corporation, in exchange solely for 25 shares of FA stock. Then Individual A transfers all the DT stock to FA in exchange solely for 75 shares of FA stock.

(ii) Analysis. Under paragraphs (i)(6) and (i)(7)(ii) of this section, the marketable securities constitute nonqualified property. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the marketable securities constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Under paragraph (b) of this section, the 25 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Accordingly, the only FA stock included in the ownership fraction is the FA stock transferred to Individual A in exchange for the DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 2. Stock transferred in exchange for property acquired with a principal purpose of avoiding the purposes of section 7874. (i) Facts. Individual A wholly owns DT. PRS transfers marketable securities (within the meaning of paragraph (i)(6) of this section) to FT, a newly formed corporation, in exchange solely for all the FT stock. Then PRS transfers the FT stock to FA, a newly formed corporation, in exchange solely for 25 shares of FA stock. Finally, Individual A transfers all the DT stock to FA in exchange solely for 75 shares of FA stock. FA acquires the FT stock with a principal purpose of avoiding the purposes of section 7874.

(ii) Analysis. Under paragraph (i)(7)(iv) of this section, the FT stock constitutes nonqualified property because a principal purpose of FA acquiring the FT stock is to avoid the purposes of section 7874. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the FT stock constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section.

Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the FT stock increases the fair market value of FA's assets by the fair market value of the FT stock. Under paragraph (b) of this section, the 25 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Accordingly, the only FA stock included in the ownership fraction is FA stock transferred to Individual A in exchange for the DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 3. Stock transferred in exchange for stock of a foreign corporation that becomes a member of the expanded affiliated group. (i) Facts. FT, a publicly traded corporation, forms FA, and then FA forms DMS and FMS. FMS merges with and into FT, with FT surviving the merger (FMS-FT merger). Pursuant to the FMS-FT merger, the FT shareholders exchange their FT stock solely for 1,000 shares of FA stock and FT becomes a wholly owned subsidiary of FA. Following the FMS-FT merger, DMS merges with and into DT, also a publicly traded corporation, with DT surviving the merger (DMS-DT merger). Pursuant to the DMS-DT merger, the DT shareholders exchange their DT stock solely for the remaining 1,000 shares of FA stock, and DT becomes a wholly owned subsidiary of FA. After the completion of the plan, FA wholly owns FT and DT, DMS and FMS cease to exist, and the stock of FA is publicly traded.

(ii) Analysis. Because FT becomes a member of the expanded affiliated group that includes FA in a transaction related to FA's acquisition of substantially all the properties of DT, the FT stock does not constitute marketable securities (within the meaning of paragraph (i)(6) of this section) and therefore does not constitute nonqualified property pursuant to paragraph (i)(7)(ii) of this section. Accordingly, no FA stock is disqualified stock described in paragraph (c)(1) of this section and therefore the FA stock transferred in exchange for the FT stock and DT stock is included in the denominator of the ownership fraction. Thus, the ownership fraction is 1,000/2,000.

(iii) Alternative facts. The facts are the same as in paragraph (i) of this Example 3, except that, instead of undertaking the FMS-FT merger, FT merges with and into FA with FA surviving the merger (FT-FA merger). Pursuant to the FT-FA merger, the FT shareholders exchange their FT stock solely for 1,000 shares of FA stock. At the time of the FT-FA merger, FT does not hold nonqualified property and has no obligations. Accordingly, FA stock transferred by FA to FT in exchange for the property of FT is not disqualified stock described in paragraph (c)(1) of this section. Furthermore, the 1,000 shares of FA stock transferred by FT to the shareholders of FT in exchange for their FT stock do not constitute disqualified stock described in paragraph (c)(1) of this section. Although the FT stock is nonqualified property (the FT stock constitutes marketable securities within the meaning of paragraph (i)(7)(ii) of this section because the stock of FT is publicly traded and FT is not a member of the expanded affiliated group that includes FA after the acquisition), under paragraph (c)(2) of this section, the transfer of FA stock by FT to the shareholders of FT neither increases the fair market value of the assets of FA nor decreases the liabilities of FA. Accordingly, no FA stock is disqualified

stock described in paragraph (c)(1) of this section and, therefore, the FA stock transferred in exchange for the assets of FT and the DT stock is included in the denominator of the ownership fraction. Thus, the ownership fraction is 1,000/2,000.

Example 4. De minimis exception. (i) Facts. Individual A wholly owns DT. The fair market value of the DT stock is \$100x. PRS transfers \$96x of cash to FA, a newly formed corporation, in exchange solely for 96 shares of FA stock. Then Individual A transfers the DT stock to FA in exchange for \$96x of cash and 4 shares of FA stock.

(ii) Analysis. Under paragraph (i)(7)(i) of this section, cash constitutes nonqualified property. Accordingly, the 96 shares of FA stock transferred by FA to PRS in exchange for \$96x of cash constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Furthermore, paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for \$96x of cash increases the fair market value of the assets of FA by \$96x. However, without regard to the application of paragraph (b) of this section, the ownership percentage described in section 7874(a)(2)(B)(ii) would be less than 5% (by vote and value), or 4% (4/100, or 4 shares of FA stock held by Individual A by reason of owning the DT stock, determined under §1.7874-2(f)(2), over 100 shares of FA stock outstanding after the acquisition). Furthermore, after the acquisition and all transactions related to the acquisition, Individual A owns less than 5% (by vote and value) of the stock of FA and DT (the members of the expanded affiliated group that includes FA). Accordingly, the de minimis exception in paragraph (d)(1) of this section applies and therefore paragraph (b) of this section does not apply to exclude the FA stock transferred to PRS from the denominator of the ownership fraction. Therefore, the FA stock transferred to Individual A and PRS is included in the denominator of the ownership fraction. Thus, the ownership fraction is 4/100.

Example 5. Obligation of the expanded affiliated group satisfied with stock. (i) Facts. Individual A wholly owns DT. The stock of DT held by Individual A has a fair market value of \$75x. Individual A also holds an obligation of DT with a value and face amount of \$25x. DT holds property with a value of \$100x, and the \$25x obligation is associated with the property. FA, a newly formed corporation, transfers 100 shares of FA stock to Individual A in exchange for all the DT stock and the \$25x obligation of DT.

(ii) Analysis. Under paragraph (i)(7)(iii)(A) of this section, the \$25x obligation of DT constitutes nonqualified property because DT is a member of the expanded affiliated group that includes FA. Thus, the shares of FA stock transferred by FA to Individual A in exchange for the obligation of DT constitute disqualified stock described in paragraph (c)(1)(i) of this section. Under §1.7874-2(f)(2), Individual A is treated as receiving 75 shares of FA stock in exchange for the DT stock ( $100 \times \$75x/\$100x$ ) and 25 shares of FA stock in exchange for the obligation of DT ( $100 \times \$25x/\$100x$ ). Thus, 25 shares of FA stock constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section

because the transfer of FA stock for the \$25x obligation increases the fair market value of FA's assets by \$25x. Therefore, under paragraph (b) of this section, the 25 shares of FA stock transferred to Individual A in exchange for the obligation of DT are not included in the denominator of the ownership fraction. Accordingly, the only FA stock included in the ownership fraction is the 75 shares of FA stock transferred to Individual A in exchange for the DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

(iii) Alternative facts. The facts are the same as in paragraph (i) of this Example 5, except that instead of acquiring the stock of DT and the \$25x obligation of DT, FA acquires the \$100x of property from DT in exchange solely for 100 shares of FA stock. DT distributes 75 shares of FA stock to Individual A in exchange for Individual A's DT stock and transfers 25 shares of FA stock to Individual A in satisfaction of DT's obligation to Individual A, and liquidates. The 25 shares of FA stock used to satisfy DT's obligation to Individual A after being transferred by FA to DT in exchange for the property of DT constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(ii) of this section because the transfer of FA stock in exchange for the property of DT increases the fair market value of FA's assets by \$100x (although the amount of disqualified stock is limited to 25 shares of FA stock in this case). Therefore, under paragraph (b) of this section, the 25 shares of FA stock that constitute disqualified stock are not included in the denominator of the ownership fraction. Accordingly, only 75 shares of FA stock are included in the ownership fraction, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 6. "Over-the-top" stock transfer. (i) Facts. Individual A wholly owns DT. Individual B holds all 100 outstanding shares of FA stock. Individual C acquires 20 shares of FA stock from Individual B for cash, and then FA acquires all of the stock of DT from Individual A in exchange solely for 100 shares of FA stock.

(ii) Analysis. Under paragraph (i)(7)(i) of this section, cash constitutes nonqualified property. Accordingly, absent the application of paragraph (c)(2) of this section, the 20 shares of FA stock transferred by Individual B to Individual C in exchange for cash would constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Nevertheless, because Individual B's sale of FA stock neither increases the assets of FA nor decreases the liabilities of FA, such FA stock is not disqualified stock by reason of paragraph (c)(2) of this section. Accordingly, paragraph (b) of this section does not apply to Individual B's sale of the 20 shares of FA stock to Individual C, and that FA stock is included in the denominator of the ownership fraction. The 100 shares of FA stock received by Individual A are the only shares included in the numerator of the ownership fraction. Thus, the ownership fraction is 100/200.

Example 7. Interaction with internal group restructuring rule. (i) Facts. P holds 85 shares of DT stock. The remaining 15 shares of DT stock are held by Individual A.

P and Individual A transfer their shares of DT stock to FA, a newly formed corporation, in exchange for 85 and 15 shares of FA stock, respectively, and PRS transfers \$75x of cash to FA in exchange for the remaining 75 shares of FA stock.

(ii) Analysis. Under paragraph (i)(7)(i) of this section, cash constitutes nonqualified property. Accordingly, the 75 shares of FA stock transferred by FA to PRS in exchange for \$75x of cash constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Furthermore, paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for \$75x of cash increases the fair market value of the assets of FA by \$75x. Therefore, under paragraph (b) of this section, the 75 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Although PRS's shares of FA stock are excluded from the denominator of the ownership fraction under paragraph (b) of this section, such shares of FA stock nonetheless are taken into account for purposes of determining whether P is a member of the expanded affiliated group that includes FA under paragraph (h) of this section. Because P holds 48.6% of the FA stock (85/175) after the acquisition, it is not a member of the expanded affiliated group that includes FA. In addition, the acquisition does not qualify as an internal group restructuring described in §1.7874-1(c)(2) because P does not hold, directly or indirectly, 80% or more of the shares of FA stock (by vote and value) after the acquisition. Therefore, the FA stock held by P (along with the FA stock held by Individual A) is included in the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 100/100.

Example 8. Interaction with loss of control rule. (i) Facts. P wholly owns DT. P transfers all of its shares of DT stock to FA, a newly formed corporation, in exchange for 49 shares of FA stock, and R transfers marketable securities (within the meaning of paragraph (i)(6) of this section) to FA in exchange for the remaining 51 shares of FA stock.

(ii) Analysis. Under paragraphs (i)(6) and (i)(7)(ii) of this section, the marketable securities constitute nonqualified property. Accordingly, the shares of FA stock transferred by FA to R in exchange for the marketable securities constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Therefore, under paragraph (b) of this section, the shares of FA stock transferred to R are not included in the denominator of the ownership fraction. Although under paragraph (b) of this section R's shares of FA stock are excluded from the denominator of the ownership fraction, under paragraph (h) of this section such stock is taken into account for purposes of determining whether P or R is a member of the expanded affiliated group that includes FA. Because P holds 49% of the shares of FA stock (49/100), P is not a member of the expanded affiliated group that includes FA, and P's FA stock is included in both the numerator and the denominator of the ownership fraction. Because R holds 51% of the

shares of FA stock (51/100), R is a member of the expanded affiliated group that includes FA and, before taking into account §1.7874-1(c), R's FA stock would be excluded from the numerator and denominator of the ownership fraction under section 7874(c)(2)(A) and §1.7874-1(b). However, the acquisition results in a loss of control described in §1.7874-1(c)(2) because P does not hold, in the aggregate, directly or indirectly, more than 50% of the shares of FA stock (by vote or value) of R, FA, or DT after the acquisition. Accordingly, the FA stock held by R would be included in the denominator of the ownership fraction under §1.7874-1(c)(1). Nevertheless, the FA stock held by R is excluded from the denominator of the ownership fraction under paragraphs (b) and (h) of this section. Thus, the ownership fraction is 49/49.

(iii) Alternative facts. The facts are the same as in paragraph (i) of this Example 8, except that, in exchange for 51 shares of FA stock, R transfers marketable securities (within the meaning of paragraph (i)(6) of this section) with a value equal to that of 16 shares of FA stock and qualified property (within the meaning of paragraph (i)(7) of this section) with a value equal to that of 35 shares of FA stock. Accordingly, 16 of the 51 shares of FA stock transferred to R constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section, and 35 of such shares do not constitute disqualified stock. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Therefore, under paragraph (b) of this section, 16 of the 51 shares of FA stock transferred to R are not included in the denominator of the ownership fraction. Although 16 of the 51 shares of FA stock that are transferred to R are excluded from the denominator of the ownership fraction, under paragraph (h) of this section, all 51 of R's shares of FA stock are taken into account for purposes of determining whether P or R is a member of the expanded affiliated group that includes FA. Because P holds 49% of the shares of FA stock (49/100), it is not a member of the expanded affiliated group that includes FA, and its FA stock is included in both the numerator and the denominator of the ownership fraction. Because R holds 51% of the shares of FA stock (51/100), it is a member of the expanded affiliated group that includes FA and, before taking into account §1.7874-1(c), its FA stock is excluded from the numerator and denominator of the ownership fraction under section 7874(c)(2)(A) and §1.7874-1(b). However, the acquisition results in a loss of control described in §1.7874-1(c)(2) because P does not hold, in the aggregate, directly or indirectly, more than 50% of the shares of FA stock (by vote or value) of R, FA, or DT after the acquisition. Accordingly, the 51 shares of FA stock held by R would be included in the denominator of the ownership fraction under §1.7874-1(c)(1). Nevertheless, the 16 shares of FA stock that constitute disqualified stock are excluded from the denominator of the ownership fraction under paragraphs (b) and (h) of this section. In addition, the 35 shares of FA stock received by R that do not constitute disqualified stock are included in the denominator. Thus, the ownership fraction is 49/84.

(k) Effective/applicability dates--(1) General rule. Except to the extent provided in paragraph (k)(2) of this section, this section applies to acquisitions completed on or after September 17, 2009.

(2) Transitional rules. For acquisitions completed on or after September 17, 2009, but before **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER]**, except as provided in paragraph (k)(3) of this section, this section shall be applied with the following modifications:

(i) Nonqualified property does not include property described in paragraph (i)(7)(iii) of this section.

(ii) A transfer is limited to an issuance of stock of the foreign acquiring corporation.

(iii) The determination of whether stock of the foreign acquiring corporation is described in paragraph (c)(1) of this section is made without regard to paragraphs (c)(1)(ii), (c)(2), and (e) of this section.

(iv) Paragraphs (d) and (h) of this section do not apply.

(3) Election. A taxpayer may elect to apply paragraphs (a) through (j) of this section to acquisitions completed on or after September 17, 2009, but before **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER]**, if the taxpayer applies those paragraphs consistently to all acquisitions completed before such date. The election is made by applying paragraphs (a) through (j) of this section to all such acquisitions on a timely filed original return (including extensions) or an amended return filed no later than six months after **[INSERT DATE**

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**REGISTER]** A separate statement or form evidencing the election need not be filed.

(l) Expiration date. The applicability of this section expires on January 13, 2017.

Par. 4. Section 1.7874-5T is added to read as follows:

**§1.7874-5T Effect of certain transfers of stock related to the acquisition (temporary).**

(a) General rule. Stock of a foreign corporation that is described in section 7874(a)(2)(B)(ii) shall not cease to be so described as a result of any subsequent transfer of the stock by the former shareholder (within the meaning of §1.7874-2(b)(2)) or former partner (within the meaning of §1.7874-2(b)(3)) that received such stock, even if the subsequent transfer is related to the acquisition described in section 7874(a)(2)(B)(i).

(b) Example. The rule of this section is illustrated by the following example:

Example. (i) Facts. Individual A wholly owns DT, a domestic corporation. FA, a newly formed foreign corporation, acquires all of the stock of DT from Individual A in exchange solely for 100 shares of FA stock. Pursuant to a binding commitment that was entered into in connection with FA's acquisition of the DT stock, Individual A sells 25 shares of FA stock to B, an unrelated person, in exchange for cash. For federal income tax purposes, the form of the steps of the transaction is respected.

(ii) Analysis. Under §1.7874-2(f)(1), the 100 shares of FA stock received by Individual A are stock of a foreign corporation (FA) that is held by reason of holding stock in a domestic corporation (DT). Accordingly, such stock is described in section 7874(a)(2)(B)(ii). Under paragraph (a) of this section, all 100 shares of FA stock retain their status as being described in section 7874(a)(2)(B)(ii), even though Individual A sells 25 of the 100 shares in connection with the acquisition described in section 7874(a)(2)(B)(i) pursuant to the binding commitment. Therefore, all 100 of the shares of FA stock are included in both the numerator and denominator of the ownership fraction (as defined in §1.7874-4T(i)(9)).

(c) Effective/applicability dates. This section applies to acquisitions that are completed on or after **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER]**.

(d) Expiration date. The applicability of this section expires on January 13, 2017.

John Dalrymple  
Deputy Commissioner for Services and Enforcement.

Approved: December 30, 2013

Mark J. Mazur  
Assistant Secretary of the Treasury (Tax Policy).